

Task Order 807: Local Government Financial Reform: Toward a Sustainable System of Local Government

SUBMITTED TO:

United States Agency for International Development
100 Totius Street
Groenkloof
0181

DEVELOPED BY:

Peter Vaz, Ph.D., Public Finance Specialist
RTI International
3040 Cornwallis Road
PO Box 12194
Research Triangle Park, NC 27709-2194 USA

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Table of Contents

SECTION	PAGE
Abbreviations	iii
Introduction.....	1
Key Successes.....	2
Key Challenges.....	7
Conclusion	11

Abbreviations

dplg	Department of Provincial and Local Government
DME	Department of Minerals and Energy
DOH	Department of Health
DWAF	Department of Water Affairs and Forestry
EDI	Electricity Distribution Industry
FFC	Financial and Fiscal Commission
IDTT	Interdepartmental Task Team
LGFR	Local Government Financial Reform
MDB	Municipal Demarcation Board
MEC	Member of the Executive Council
MFMA	Municipal Finance Management Act
MFMB	Municipal Finance Management Bill
MINMEC	Committee of Ministers and Members of Executive Council
MSA	Municipal Structures Act
MSAA	Municipal Structures Amendment Act
MTEF	Medium-Term Expenditure Framework
PCC	President's Coordinating Committee
RSC	Regional Services Council
RTI	Research Triangle Institute
SALGA	South African Local Government Association
TLCs	Transitional Local Councils
USAID	United States Agency for International Development

Introduction

The initial purpose of this delivery order (which began in January 2001) was to assist the South African government in policy analysis on local government revenue, expenditure and related topics. The final outputs of the Local Government Financial Reform (LGFR) project were to assist the Department of Provincial and Local Government (**dplg**) to first produce a fiscal information database, and, second, utilize the data from the database, plus data from additional sources, to produce a policy study that would result in three working papers in the following areas: division of fiscal powers and functions between categories of municipalities, financing of district municipalities, and local government's equitable share of nationally raised revenue. The project was completed in September 2001 and all outputs were delivered to USAID. In order to support the continued process of local government transformation, a resident advisor, Peter Vaz, was appointed to **dplg** for a 24-month period from October 2001 to September 2003. The contract was further extended at no cost to July 31, 2004. The objectives of the resident advisor were to develop and regulate frameworks for municipal finance matters and intergovernmental fiscal relations.

Local government has been undergoing a three-phase process of transformation since the first democratic elections. The pre-interim phase from the adoption of the interim Constitution in 1993 to 1996 had over 1,200 municipalities. The interim phase from the time of the adoption of the new Constitution in 1996 to 2000 reduced the number of municipalities to 843. The final phase from the time of local government elections in December 2000 further redemarcated municipalities into the following wall-to-wall municipalities (combining rural and urban): 6 Category A (metropolitan), 231 Category B (local) and 47 Category C (district) municipalities. The final phase has been further divided into three subphases—establishment/amalgamation (2000-2002), consolidation (2003-2005) and sustainability (2005 onward). The establishment phase is concerned with building new structures and systems at the local level and finalizing local government legislation, policy and regulations at the national and provincial levels. The consolidation phase involves the final division of powers and functions between category B and C municipalities and any remaining legislation, policy and regulations. The sustainability phase involves full-scale implementation of local government legislation, policy and regulations.

Key Successes

The key successes of the project include the following.

1. Contribution to successful collaboration between **dplg** and National Treasury on key policy issues

A peer-reviewed journal article,¹ co-authored by Silvia Dorado and Peter Vaz, describes how the LGFR project succeeded in facilitating a closer working relationship between the two departments. Historically, **dplg** and National Treasury have had different perspectives due to their differing roles with regard to intergovernmental fiscal relations. **dplg** views local government as a whole and concerns itself with the welfare of all three categories of municipalities, while National Treasury is more concerned with the six metropolitan and 20 or so larger local municipalities. **dplg**'s major focus is on service delivery while National Treasury's is on financial management.

A crucial part of RTI's role in the project was the convening of regular meetings between **dplg** and National Treasury and the coordination of a reference group comprised of national government sectoral officials. The meetings aimed at getting the two departments to reach agreement on policy around key issues related to fiscal decentralization. The reference group provided a forum for RTI to present key project findings and get buy-in from the key stakeholders in the project. A factor critical to the success of the project was that, for the duration of the LGFR project, USAID placed RTI advisors in each of the two departments. With an RTI-led team at **dplg**, coordination and problem solving with National Treasury could take place on an informal level within RTI, in addition to formal channels.

2. Gazetting of authorizations by Minister for Provincial and Local Government ("the Minister") on division of powers and functions between Category B and C

¹ Dorado, Silvia and Peter Vaz. 2003. "Conveners or Champions of Collaboration in the Public Sector: A Case from South Africa." *Public Administration and Development*, Vol. 23, pp. 141-150. U.K.: John Wiley and Sons.

municipalities and implementation of certain key sections of the Municipal Structures Act

The Municipal Structures Act (MSA) of 1998 divided powers and functions between Category B and C municipalities. It provided for a fairly flexible arrangement, based on capacities of municipalities. The Municipal Structures Amendment Act (MSAA) of 2000, however, placed four “national” functions—water, sanitation, electricity, and municipal health—and several other functions that were previously with Category B municipalities at the Category C level. The Minister can authorize Category B municipalities to perform the four national functions and the Member of the Executive Council (MEC) in each province can authorize Category B municipalities to perform the other functions. In order to minimize disruptions in service delivery, the Minister, in November 2000, authorized Category B municipalities to perform the four national functions in the areas of the former Transitional Local Councils (TLCs) within them—referred to as the “status quo.”

However, maintenance of the status quo left the situation fluid, and created uncertainty for municipalities in terms of their budgets and planning activities. Medium-term budgets and effective integrated development plans could not be drawn up until clarity was achieved. The prevailing situation also gave little comfort to private sector investors whose planning horizon extends well beyond the two-year transitional period. It created uncertainty and was hence likely to impede both existing and future lending arrangements. This situation also delayed the completion of the establishment/amalgamation phase of local government transformation.

Dr. Vaz played a significant role in coordinating a process for **dplg** that led to the gazetting (i.e., publication in the government gazette) of Ministerial authorizations on January 3, 2003. He coordinated (with Karen Harrison from **dplg**) an Interdepartmental Task Team (IDTT), consisting of officials from **dplg**, National Treasury, Department of Water Affairs and Forestry (DWAF), Department of Health (DOH), Department of Minerals and Energy (DME), South African Local Government Association (SALGA), Financial and Fiscal Commission (FFC) and

Municipal Demarcation Board (MDB). The IDTT presented a consensus report to the key Ministers, to the President's Coordinating Committee (PCC) and to the Local Government Committee of Ministers and Members of Executive Council (MINMEC). Dr. Vaz played a vital role in providing support during the high-level consultation process during which the Minister interacted with his counterparts in other relevant ministries and with the provincial MECs.

Dissemination of information about these **dplg** decisions was another critical task. For example, Dr. Vaz participated as part of a six-person team in communicating the Minister's decisions at district-level workshops throughout the country between January and March 2003. These workshops were designed to provide practical guidance to municipalities on implementing the Minister's decisions. Dr. Vaz also participated in provincial-level workshops on interim arrangements to give effect to the Minister's decisions on water and sanitation between then and July 1, 2003. Where possible, a **dplg** official conducted both sets of workshops together with Dr. Vaz, but in a number of instances he was required to conduct the workshops single-handedly.

The RTI advisor's contribution was further relied upon during 2003-04 in providing practical guidance on final arrangements (including Section 78 processes required by the Municipal Systems Act) for water and sanitation and on arrangements for implementing the municipal health decision (which took effect from July 1, 2004).

Finally, Dr. Vaz assisted with the preparation of a question-and-answer booklet and a guideline document for the implementation of the division of powers and functions for water and sanitation. These documents were distributed to all municipalities at the workshops.

3. Passage of Property Rates Legislation

The resident advisor contributed immensely in shaping the policy developments on the Property Rates Bill, including assessments of the likely financial implications for municipalities of various policy proposals. This work resulted in Cabinet approving

the Bill for introduction into Parliament in 2003. Dr. Vaz was also asked to represent **dplg** in several district-level workshops between January and March 2003 to inform municipalities and organized agriculture about the Bill and to facilitate interaction between municipalities and organized agriculture around property rating issues. He was identified as one of three people at **dplg** (the two others being **dplg** officials—Jackie Manche and Mizilikazi Manyike) who would be able to deal with this process in an informed manner.

Dr. Vaz's technical expertise was further relied upon when the Bill was processed through Parliament in 2003-04. Again, he was one of a three-member team that took the Parliamentary Portfolio Committee on Provincial and Local Government (chaired by Yunus Carrim) through a clause-by-clause briefing of the Bill. He participated in various subcommittees that were convened on agriculture, public service infrastructure and other issues. The Bill was approved by Parliament on March 4, 2004, and signed into law by the President on May 11, 2004. Dr. Vaz then assisted in the preparation of a "key information booklet" on the Property Rates Bill. This booklet was distributed to municipalities and to representatives of organized agriculture at the workshops.

There is significant work outstanding on preparing regulations, developing guidelines, assisting municipalities with implementing the Act and assisting **dplg** with monitoring the implementation. There is also work outstanding on harmonizing the Property Rates Act, the Communal Land Rights Bill and the White Paper on Traditional Leaders. Dr. Vaz was requested by **dplg** to be part of an interdepartmental team dealing with this issue during 2003-04.

4. Gazetting of Equitable Share Allocations for Municipalities in the Division of Revenue Act for the 2003/04 Medium-Term Expenditure Framework (MTEF) and Medium- to Long-Term Review of the Formula

The RTI advisor worked closely with **dplg** and National Treasury officials to finalize the equitable share model and allocations for the 2003/04 to 2005/06 Medium-Term Expenditure Framework (MTEF) period. The main issues in this regard relate to the

division of powers and functions, free basic services and nodal allocations. These allocations were gazetted in the Division of Revenue Act in April 2003. The gazetted allocations include the Basic Services Grant (S grant) and Municipal Institutional Grant (I grant), nodal allocations, and additional allocations for free basic services and free basic electricity.

Dr. Vaz also worked with **dplg**, National Treasury, the FFC and SALGA on the medium- and long-term issues around the equitable share model, mainly the inclusion of fiscal capacity into the formula. This is critical ongoing work and the RTI advisor's technical expertise was invaluable in the 2004-05 MTEF deliberations on the equitable share.

5. Processing of Municipal Finance Management Bill (MFMB) through Parliament

dplg was actively involved in the MFMB hearings in Parliament. Dr. Vaz attended internal department meetings to prepare for **dplg**'s involvement and assisted **dplg** at Parliamentary Portfolio Committee meetings. The main issues that **dplg** is concerned with are the sections related to financial emergencies and the synchronization of the Bill with the Constitution, the Municipal Structures Act and the Municipal Systems Act. With regard to financial emergencies, **dplg** was also involved with proposed Constitutional amendments. Dr. Vaz was also involved in the preparation of the monitoring, support and intervention framework that formed the policy backdrop for the chapter on financial emergencies. The Bill was signed into law by the President late in 2003 and was being implemented in a phased manner as of July 1, 2004. It sets the stage for responsible and internationally recognized financial management practices.

6. Restructuring of the Electricity Distribution Industry

Dr. Vaz was involved in deliberations between DME and **dplg** around the issue of electricity restructuring. DME submitted two Cabinet memos, dealing with (1) key policy issues relating to the electricity distribution industry and (2) the Electricity Distribution Industry (EDI) Restructuring Bill. Dr. Vaz coordinated **dplg**'s response

to the two Cabinet memos. He also led the discussions at bilateral meetings between **dplg** and DME on the two Cabinet memos before they went to Cabinet. As a result of these meetings, agreements were reached between the two departments to amend the Cabinet memos and the Bill. Dr. Vaz played a vital role in high-level consultations between the **dplg** Minister and the Minister for Minerals and Energy that resulted in reshaping the EDI Restructuring Bill that was to be gazetted for public comment in late summer 2004. His technical contribution resulted in the Bill being redrafted to protect the interests of municipalities and the income they receive from electricity reticulation.

7. Other Contributions

Apart from the specific contributions mentioned above, Dr. Vaz advised **dplg** on various policy issues that have—or are likely to have—impact on municipal finances. He also advised the Department on various Cabinet memoranda, policy documents, and draft legislation coming from various national government departments, including the Department of Environmental Affairs and Tourism, Department of Land Affairs, National Treasury and so on.

The RTI advisor also assisted the Department on various policy initiatives beyond his scope of work, such as the review of Schedules 4 and 5 of the Constitution, policy and legislation on intergovernmental relations, an assignment framework for the devolution of functions, and the National Capacity Building Framework.

Key Challenges

The project has not been without its challenges, as described below.

1. High Turnover of **dplg** Staff

One of the biggest challenges facing the project has been the high turnover of **dplg** staff in the past 4½ years. Some key staff with whom Dr. Vaz worked directly, and whose capacity he helped build, have left **dplg**. This is one of the reasons accounting

for **dplg**'s dependence on Dr. Vaz as a resident advisor since he became one of the few people at **dplg** who had the institutional memory on all issues related to local government financial and institutional issues and intergovernmental fiscal relations. As recently as February 2004, **dplg** lost a Chief Director of Intergovernmental Fiscal Relations and a Director of Fiscal Transfers. In June 2004, the Deputy Director General for Systems and Capacity Building left **dplg**. Thus, a large part of Dr. Vaz's work in the last few months of his contract included filling the void left by the Chief Director and Director, bringing the new Chief Director and Director (who joined in May 2004) up to speed on issues and briefing the Acting Deputy Director General (who assumed the post in July 2004).

2. Local Government Fiscal Framework

The LGFR project made recommendations on the equitable share, the division of fiscal powers and functions, and the reform of the Regional Services Council (RSC) levy. During his tenure as a resident advisor, Dr. Vaz was involved in drafting Cabinet memoranda on the division of fiscal powers and functions and the reform of the RSC levy. National Treasury stopped these Cabinet memoranda on the grounds that they were done in the absence of an overall local government fiscal framework. National Treasury has hired consultants (through a World Bank grant) to work on the local government fiscal framework over the next 15 months. This is crucial work with regard to the future of local government finances. It is very important that **dplg** has the necessary support to enable it to engage with National Treasury on this outstanding policy issue. **dplg** is the champion of fiscal decentralization in South Africa while National Treasury is much more centralistic in its approach. Any movement away from a trend of fiscal decentralization could have very serious consequences for local government fiscal autonomy.

The President, in his State of the Nation address, promised that there would be a review of the equitable share formula for local government by December 2004 and some finality on the issue of EDI restructuring by July 2004. Both these issues are very closely linked to the local government fiscal framework. The local government

equitable share needs to be regarded as the last piece in the fiscal framework, once all own-source revenues for local government have been exhausted. The EDI restructuring has serious financial consequences for municipalities and this needs to be considered in the overall context of the local government fiscal framework.

Given that **dplg** has suffered a loss in capacity, it is crucial that someone with in-depth institutional knowledge of local government finances similar to Dr. Vaz works closely with **dplg** over the next 9 to 12 months to ensure that **dplg** is able to review and monitor National Treasury's policy approach on the local government fiscal framework and contribute significantly to the debates and Cabinet submissions on the above matters.

3. Implementation of Legislation

The proper implementation of both the Property Rates Act and MFMA has very important implications for local government finance. As mentioned earlier, the MFMA will facilitate better data collection across the country. It will also help to create more transparency and accountability in local government budgets. The Property Rates Act needs regulations and guidelines and a proper communications strategy to ensure that municipalities implement it correctly and wisely. If these are not done, there is the danger that municipalities may end up imposing rates that are detrimental to local economic development and may even materially and unreasonably prejudice national economic policies.

4. Division of Fiscal Powers and Functions Between Category B and C Municipalities

The Constitution mandates that when two municipalities in the same geographic area have the same fiscal powers and functions, national legislation must come up with an appropriate division of these powers and functions. The Minister's authorizations and the MEC adjustments of powers and functions between Category B and C municipalities have a direct bearing on this matter in keeping with the public finance principle that finance must follow function. All the functions authorized by the Minister, with the exception of municipal health services, are self-financing in nature

because they are linked to a tariff or user charge. However, most of the functions adjusted by the MECs are not self-financing. In addition to the problem mentioned earlier that the division of fiscal powers and functions needs to be done within the context of a local government fiscal framework (which is still being formulated), the Municipal Structures Act enables MECs to adjust powers and functions regularly, after considering recommendations by the Municipal Demarcation Board (MDB). The MDB makes annual recommendations to MECs so powers and functions are quite frequently adjusted between the two categories of municipalities. This instability in the expenditure responsibilities of Category B and C municipalities makes it very difficult to come up with an appropriate division of fiscal powers and functions. A possible solution is to amend the Municipal Structures Act to limit the powers of the MECs to adjust powers and functions. Again, this is a major policy issue that needs to be sorted out in the next year.

5. Municipal Revenue Enhancement Programme

dplg has created a new directorate, called Municipal Viability, within the Intergovernmental Fiscal Relations Chief Directorate. This directorate will be responsible for the coordination and implementation of a Municipal Revenue Enhancement Programme. This includes elements such as finalization of the indigent policy, reduction in government arrears to municipalities, and the like. It will also deal with assisting municipalities with strategies to improve billing and collection systems. Given that this is a new aspect of **dplg**'s core business, it will need assistance and capacity building to achieve its objective of building financially viable and sustainable local government.

6. Local Government Fiscal Information Database

The LGFR project attempted to create a local government fiscal information database that would be housed at **dplg**. This endeavor met with limited success. The biggest problem was the fact that the database was constructed in the periods before and after the 2000 municipal demarcation and elections. At the time the project began in January 2000, there were 843 transitional municipalities in the country. Thus, data

were collected on the basis of these 843 entities. By the time the project ended, they had been redemarcated to 284 municipalities. There were, thus, problems with mapping the old system to the new. In addition, there was no uniform format or system for collecting municipal data. The lack of standardization of data across different data sources led to many discrepancies in the creation of the database. This problem will now be reduced with the new budget reforms and the passage of the Municipal Finance Management Act (MFMA). In fact, over the next few years, when the system of local government has reached the sustainability phase, is the ideal time to develop such a fiscal information database.

Conclusion

In conclusion, USAID's support to **dplg** through element 1 of the Local Governance Support Program (under which Dr. Vaz was funded) not only has led to significant policy and legislative achievements, but also has translated to implementation issues that critically impact the ability of municipalities to move from the establishment/amalgamation phase to the consolidation and sustainability phases of local government transformation. Although municipalities are now supposed to be in the consolidation phase, the majority only recently completed the establishment/amalgamation phase. In addition, local government elections are coming up in December 2005. There is still significant policy, legislative and ongoing implementation work outstanding. **dplg** will consequently benefit immensely from continued policy assistance in 2004/05.